AFFORDABLE RENTAL HOUSING SUPPLY:

The Dynamics of the Market and Recommendations for Encouraging New Supply

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Table of Contents

I	Introduction	3
II	Sources of Affordable Rental Supply	5
	Older Rental Stock	5
	Secondary Rental Market	5
	Government Subsidized Rental Housing	7
	Shelter Subsidies	10
III	The Dynamics of Private Sector Rental Development	12
	Rental Housing Starts in Ontario	13
	Canada-U.S. Comparison	15
IV	Impact of Government Policies on Rental Housing Development	19
	Market Rental Housing	19
	Impact of Government Supply Programs	26
	Municipal Policies	26
	Recent Provincial Initiatives to Encourage New Rental Supply	29
V	Recommendations	30
	Appendix: Survey of Selected Municipalities on Efforts to Promote the Building of Affordable Rental Units	36

I Introduction

Canada's urban regions are experiencing a severe shortage of affordable rental housing, with construction at a near standstill. This shortfall, combined with significant population increases, has brought vacancy rates to all-time lows in many cities and pushed rental costs beyond the reach of many Canadians.

The problem is particularly acute in Ontario where vacancy rates are below 2% in most urban centres - 0.6% in Toronto and 0.2 % in Ottawa - and average rents have increased by considerably more than inflation - up 7% in Toronto and 12% in Ottawa over the last year.[1] Rental housing starts, while showing modest gains in the past few years, are still at very low levels. It is estimated that Ontario starts will total just over 2,000 for the year 2000. [2]

This lack of strength in the rental market is despite a very strong economy in the province. The Ministry of Finance estimates that real GDP grew by 5.5% last year and that unemployment was 5.7%, the lowest rate since 1989. Urban area housing starts within Ontario are estimated to be over 67,000, the highest since 1989.

The impact of virtually no new rental supply and the consequent upward pressure on rents is felt in many areas:

- There is increasing pressure on all levels of government for assistance to low income households so that they can afford suitable and adequate housing.
- There is increasing pressure on other social services from poorly housed or homeless individuals who, in the absence of adequate housing, lose their ability to cope with other aspects of life.
- Job-creating investment is put at risk when corporations consider the adequacy of the housing stock in making locational decisions and find limited choices and an aging stock.
- There is an increasingly limited ability to house new immigrants - a major component of Canada's labour force - as the bulk of new comers seek rental housing.
- Opportunities for compact urban development are lost, as rental development, which typically promotes intensification by occurring in more built up areas, close to - and thus supporting - public transit, is forgone.

All levels of government must take ownership of the problem and recognize that, while governments lack the fiscal resources to directly subsidize all renter households currently in housing need, the ability exists to improve the investment climate so that rental development once again becomes viable and the market as a whole starts to work again.

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[1] CMHC annual rental market survey, November 2000; rent increases referred to above for a 2 bedroom apartment

[2] This number overestimates actual purpose built rental housing starts since it includes life leases.

As this paper will argue, even rental development at the high end increases affordability, because it adds to the overall stock, putting downward pressure on rents and freeing up more affordable units as higher income tenants move into the new supply.

With a functioning market for rental development, the cost of developing strategies to directly address rental afford bility becomes less prohibitive. It is clear, historically, that even with significant private sector rental development, there will always be a need for some government role in assisting low-income households with housing affordability and other income problems. The challenge for government is to ensure that the existing investment environment promotes a sustained and healthy rental development market so that the cost of directly subsidizing affordability is minimized.

Private rental supply needs to increase dramatically to meet Canada Mortgage and Housing Corporation's estimated requirement for approximately 16,000 new rental units in Ontario, annually, over the next 20 years. At present, CMHC is projecting a shortfall of between 12,000 and 15,500 units. If unmitigated, this shortfall will have significant implications:

- Competition for existing affordable rental units will intensify, giving tenants at the lowest end of the income spectrum little choice or no choice - homelessness and the resultant pressure on shelters and other social services will increase.

- The number of individuals in existing rental units will increase, along with the potential for public health and social problems associated with overcrowded housing conditions.

- Household formation will be delayed as young people are unable to find affordable rental accommodation.

II Sources of Affordable Rental Supply

Affordable rental supply has traditionally come from four sources:

- older rental stock that becomes available to lower income tenants as higher income tenants move into new rental units or ownership housing;
- the secondary rental market, such as basement apartments and apartments over stores;
- government subsidized rental housing, which includes direct subsidies through program spending targeted at social housing providers or private developers/ landlords;
- and shelter subsidies - government subsidies to households to be used towards rent.

Older Rental Stock

Developments targeted at high-end renters are the most economically attractive for developers and thus are usually the only projects that the private sector is willing to build on its own. However *any* new rental projects add to the overall supply of rental housing - and thus are beneficial to tenants across the rent spectrum. This is because the new supply at the upper end of the market draws higher income tenants that in the absence of this supply would have stayed in units in the older existing stock. By absorbing the demand for high end rental units, the new rental supply frees up a supply of existing units for more modest income tenants. In the absence of the new supply, these modest income tenants would have been forced to compete for existing units with higher income tenants. In turn, the newly created rental units will become less attractive over time, relative to more recently built units, and thus move into the more affordable portion of the market.

In addition to freeing up older, more affordable rental units, new rental housing can divert *new* rental demand away from the more affordable existing stock. New entrants to the rental market with relatively high incomes will often prefer new higher end rental units. (A classic example is the lifestyle seniors market; couples and singles who sell their single detached home and move into rental housing)

Development of affordable *ownership* housing has an effect similar to that of high end rental development in that it tends to attract higher income tenants out of existing units. Thus encouraging the development of affordable ownership housing can help relieve pressure on the existing rental stock.

Secondary Rental Market

While there has been a substantial decline in the volume of purpose-built rental housing over the past two decades, there has been a partially offsetting increase in the volume of "non-conventional" or secondary rental market housing. The secondary rental market

(defined as tenant-occupied single, semi and row dwellings; rented condominium units; accessory apartments such as self-contained basements and flats; and apartments over stores) is now the most significant source of affordable rental housing (*Most* forms of secondary rental market housing are relatively affordable, such as basement apartments and apartments over stores. Rented condominium units, however, are generally not - they tend to be substitutes for high end purpose built rental. Like high end rental, however, rented condominiums help to relieve pressure on the existing stock of purpose built rental.)

The secondary rental market comprises a large portion of the overall rental market. The recently commissioned *Secondary Rental Market Study* [3] found that the secondary rental market accounts for the following portions of the overall rental market:

- 35% in the City of Toronto
- 73% in Suburban GTA
- 50% in Ottawa
- 43% in Hamilton
- 48% in Kitchener-Waterloo
- 48% in Windsor
- 55% in Sudbury

While the secondary rental market plays an important role in providing affordable rental housing, it is a less secure source than purpose built rental housing. The sustained availability of secondary rental market housing depends heavily on economic and real estate conditions and thus it cannot be counted on as a stable long-term supply. (For example, some families will only rent out a basement apartment when their financial situation necessitates.)

Different municipalities have different zoning by-laws governing secondary units in houses. For instance, the City of Toronto allows basement apartments built to code, but many of the 905 area municipalities have exclusionary type zoning that makes it very difficult to have secondary units. Development charges can also be a significant deterrent. For example, a full development charge would apply on a basement apartment, which makes them prohibitive in places with high development charges such as Vaughan, Markham, Oakville and Mississauga. Other effectively exclusionary zoning requirements, like provision of excess parking, further discourage legal secondary units in the GTA outside of the City of Toronto.

Recently, growth in the secondary rental market has been stagnant: the *Secondary Rental Market Study* found that most forms of secondary rental market housing have not been growing in most communities. Because of the lack of recent expansion of these markets, vacancy rates for such forms of housing are now quite low in most centres. Rents for most

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[3] This study, undertaken by The Starr Group Inc., was jointly commissioned by the Ontario Ministry of Municipal Affairs and Housing and Canada Mortgage and Housing Corporation. It was released in November of 2000.

forms of secondary rental housing have been rising sharply in most areas, consistent with low vacancy rates in both the secondary and conventional markets. The report concluded that even the most affordable forms of secondary rental housing - accessory apartments, units over stores and duplexes/triplexes - are increasingly moving out of reach of those at the lower end of the income scale.

Nevertheless, the *Secondary Rental Market Report* argues that, despite the recent tightening of this market, it has the potential to become an even more significant provider of affordable rental housing with the appropriate government policy support. As such, the secondary rental market must be a key component in any overall affordable housing strategy. Strategies to promote the secondary rental market will be dealt with in the final Housing Supply Working Group report.

Government Subsidized Rental Housing

The federal and provincial governments' response to the poor economics for private sector development of affordable rental housing has generally been to subsidize affordable supply through program spending targeted at social housing providers or private developers/ landlords.

Historically, most rental housing that has been affordable at the time it was built has been subsidized. Over the last fifty years, direct program spending - either direct subsidies to private sector developers/landlords or direct subsidies to government owned or non profit social housing - have created the bulk of new affordable housing.

A number of federal and provincial programs providing direct subsidies to private developers and landlords encouraged the development of affordable rental housing. Common program features included below market or no interest loans and deferred payment of the principle. For example, Renterprise, a provincial program in place between 1986 and 1988, offered 15 year, interest free loans to builders to bridge the gap between economic and market rents. (See tables 1 and 2 below for examples of government programs.)

Direct government subsidies to government owned or non profit social housing have also been significant over the years. With the cancellation of federal social housing programs in 1993, the provincial non profit housing programs in 1995, and the devolution of responsibility for social housing to Consolidated Municipal Services Managers[4], no new government subsidized units are being built.

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[4] Consolidated Municipal Service Managers are municipal entities responsible for the delivery of Ontario Works, child care and social housing.

Table 1 : Affordable Rental Housing Programs to Encourage Private Sector Rental Housing

Community Integrated Housing Program (Provincial) 1973	Province provided second mortgage financing for modest rental. Financing at below market rates. Borrowers had to provide 25% of units to the provincial rent supplement program (tenants pay rent geared to income and province pays balance of rent, which is set at market rates).
Ontario Accelerated Family Rental Housing (Provincial) 1973	Province provided first mortgage financing for modest rental. Financing for 95% of cost, 50 year amortization, below market rates. Borrowers had to provide 25% of units to rent supplement program.
Private Assisted Rental Program (Provincial) 1976-1985	Province arranged with developers to build modest rental housing and guaranteed up to 100% of the units would be brought into the rent supplement program (with Province guaranteeing to pay the difference between tenants' RGI rent and the market rent).
Ontario Rental Construction Loan (Provincial) 1981-1984	Second mortgage loans of $4200 to $6000 per unit to developer for construction of market rental housing. Loan was interest free for 25 years; principal repaid from year 16 to 25. 14,540 units were produced at a cost of $75 million.
Renterprise (Provincial) 1985	Second mortgage loans to developers for modest rental housing. Loan was interest- and payment-free for 15 years; could be repaid in year 16 or from years 16 to 25 at then prevailing interest rates. Loan amount varied depending on construction costs. 2,176 units were produced at a cost of $15.4 million.
Canada-Ontario Rental Supply Program (CORSP) (Provincial - Federal) 1984	A joint federal-provincial program, which provided loans to developers to build modest rental for families. Loans were interest free and repayable starting in the 15th year. 2,675 units were produced at a cost of $29.4 million.
MURB (Federal) 1974-1979	A significant program but not targeted to affordable rental , MURB was a tax expenditure program that operated through the federal tax system. The MURB program was a tax deferral program in which owners of eligible rental units could defer non-rental income tax by writing off certain "soft costs" (promotion expenses, mortgage fees, legal and accounting fees, interest expense during construction, and interest and property taxes) 195,000 units were produced nationally at a cost of $2.4 billion in forgone tax revenue.
Limited Dividend Program (Federal) 1946-1975	Developed to increase the supply of moderately priced rental housing for low income persons. CMHC made loans to finance new construction and for the purchase or improvement of existing buildings. Loans were for 95% of a project's capital costs and were set at a below market rate of interest. In return, building owners allowed CMHC to control rents in their buildings. Rents were set to allow owners an "acceptable rate of return on their investment (5%) but were still affordable to low-income households. 101,300 units were produced nationally.

Table 2: Social Housing Programs

Non-Profit and Coop (Various Provincial and Federal Programs)	Terms varied from low-interest loans to interest subsidies to 100 percent insured loans plus grants to offset operating expenses.

Public Housing (Various Provincial and Federal Programs)	Under various federal/provincial arrangements, each level of government shared capital costs and operating costs for projects aimed at the needy.
Rent Supplement (Provincial)	Rent geared to income for tenants in rental housing, with government paying the balance of the market rent to the landlord.

Shelter Subsidies

Shelter subsidies - which subsidize the demand for rather than the supply of rental housing - have been used by the federal and provincial governments less frequently. The focus of federal housing programs has been almost entirely on encouraging new supply. While the province has had a rent supplement program for several decades - which was recently enhanced by the use of $50 million in savings from the signing of the federal-provincial social housing agreement - neither level of government has implemented a widespread program of shelter subsidies, other than the provincial designation of a portion of a welfare recipient's cheque as being for housing (Shelter subsidies differ from rent supplements in that they are attached to a particular household rather than a particular rental unit.)

In spite of having to fund shelter subsidy programs unilaterally, British Columbia, Manitoba, Quebec, New Brunswick and Nova Scotia have all had such programs. In the U.S., the Department of Housing and Urban Development spends about $13 billion annually on housing vouchers. (The next largest program in the U.S. is the supply side based Low Income Housing Tax Credit program with an annual budget of about $3 billion annually). These programs, particularly in the U.S., have generally been found to be a cost-effective way of providing affordable housing. In Canada, the withdrawal of the federal government from cost-sharing new social housing programs may encourage an emphasis towards shelter subsidies in the future.

Shelter subsidies have a number of advantages over supply side strategies:

- Less costly - They can provide an equal level of affordable housing for significantly less than the cost of new construction, which tends to have a premium associated with it.

- Horizontal equity - It is easier to ensure that people of equal need are subsidized to the same extent. A key problem with public housing has been the lottery aspect of it in that some needy households are fortunate and able to obtain it while others in similar circumstances receive no form of subsidy.

- Maximum choice - Households are given a portable subsidy that can apply to whatever rental housing they choose.

- Affordability is immediately and directly addressed - Unlike some supply side programs where it is difficult to ensure ongoing or even initial affordability, shelter subsidies clearly increase affordability on an immediate and sustained basis.

Shelter subsidies, however, are sometimes seen as having the following disadvantages:

- Benefits captured by landlords - It is argued that some of the subsidy will go to landlords because rents will be set higher than they would in the absence of subsidy. However, recent empirical evidence provides little support to this

contention: a recent U.S. study of housing vouchers showed little evidence of rent inflation.[5] As well, the Mayor's Homelessness Action Task Force Report argued that a housing allowance would not inflate or dictate market rents in Toronto.[6]

- Program cost is too open ended - There is often concern that, because all who qualify are entitled to subsidy, governments may not be able to contain their spending on the program. Work by housing economist Marion Steele suggests that this has not been a problem in the provinces which have implemented shelter subsidy programs and that in fact shelter subsidies are a more cost effective way to provide affordable housing[7].

- There may be insufficient private sector produced rental housing for a shelter subsidy system to work - This is most likely to be a problem in isolated areas, for instance, northern communities.

- Shelter subsidies do not create new supply - Given the current situation of negligible new rental production, a system of shelter subsidies alone cannot solve the problem of rental demand outstripping supply.

It is clear that, while shelter subsidies may be a cost-effective and immediate way of ensuring rental affordability for needy households, they are not appropriate in all circumstances and, in particular, cannot be the sole focus of government housing policy when rental supply remains an issue. Nonetheless, shelter subsidies can be an effective complement to supply side strategies in ensuring that both affordability and supply issues are appropriately addressed.

An optimal private sector based approach to ensuring sufficient affordable supply may be to consider shelter subsidies and/or U.S. type tax credit programs that encourage private sector development of affordable supply.

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[5] Galster, George (1997) "Comparing Demand-Side and Supply-Side Housing Policies: Sub-Market and Spatial Perspectives" in Housing Studies (Volume 12, Number 4), pp. 561-577.

[6] City of Toronto (January 1999), Taking Responsibility for Homelessness : An Action Plan for Toronto. (Toronto: Mayor's Homelessness Action Task Force)

[7] Steele, Marion (1985), "Housing Allowances: An Assessment of the Proposal for a National Program for Canada", a report prepared for the Canadian Home Builders Association.

III The Dynamics of Private Sector Rental Development

The economics of the rental market are such that regardless of the business climate, developers will tend to build at the high end of the market, where economic viability is greatest. Improvement in business climate conditions (See Table 3) will encourage an increase in new rental development but will not increase the *relative* attractiveness of building low end rental market housing: even in the most favourable business climate, it will generally be more profitable to build for the high end of the market.

Table 3: Key Business Climate Conditions Affecting Private Sector Rental Housing Investment

Income Taxes and GST	The federal income tax environment has a large impact on the economics of rental investment and is one of the most important factors in private sector investment in rental housing. The preferential tax treatment of rental housing that existed until into the 1970's and the absence of the GST helped encourage the creation of most of the province's purpose built rental housing stock in the 1960's and 70's.
Property Taxes and Development Charges	Property taxes, which typically account for about 20% of rent, have a significant impact on the ongoing returns available from rental investments. Although there have been some recent reforms to the property tax system, multi-residential buildings (purpose built rental buildings) generally still pay disproportionately high property taxes compared to ownership housing, including condominium projects. Development charges, introduced to provide municipalities with a revenue source to pay for the incremental infrastructure associated with new development (senior government grants for this purpose declined in the late 80's and early 90's) also have a significant effect on rental housing economics.
Rent Control and Landlord-Tenant Legislation	Rent controls discourage investment in rental housing in two ways: by putting a ceiling on rents, they limit investment returns and, because they are subject to change when governments change, they represent an additional risk to the cash flow from a potential project. Similarly, landlord-tenant legislation may be subject to changes in ways that impose additional costs on rental investors (such as changes in the ability of landlords to evict tenants for non payment of rent or changes in the ability of landlords to recover the cost of capital repairs). Finally, the existence of any anti-conversion laws affects the perception of rental investment profitability, making rental investment less attractive relative to other real estate investments.
Level of Interest rates	The cost of borrowing money has a profound effect on the amount of money that a developer will be able to borrow (the lender will want to ensure that debt servicing and other operating costs do not exceed the expected cash flow from the project) and a direct impact on a potential project's return. Since the general level of interest rates also affects the return on alternative investments (particularly fixed income investments such as bonds and GIC's), it will affect the relative attractiveness of rental housing investment.
Access to Financing and Cost of Mortgage Insurance	Mortgage insurance allows developers of rental housing to borrow more than 75% of the cost of a project. This allows borrowers to not only obtain a high ratio mortgage, and thus reduce the equity required for a project - and thereby increase their return on equity - but it also allows them to borrow money at rates lower than they would be able to obtain without insurance.

Volume building of modest cost *ownership* housing can approach the profitability of building smaller quantities of high end ownership housing or at least still produce an

acceptable return to the builder. The same does not apply to affordable rental: the cost of building affordable rental is typically only slightly less than building high end while the income stream available from it is significantly less making potential returns unattractive (relative to other investment opportunities) in almost any business climate.

It should also be noted that the incomes of a significant number of households are simply too low to allow them to pay rent, let alone a mortgage. Building and land costs put new housing out of the reach of many low income households. As the costs associated with the existing stock of housing, whether rental or ownership, are beyond many low-income households, it is not reasonable to expect them to be able to afford *new* housing.

Thus in the absence of subsidy, the private sector is unlikely to build new rental housing for the low end of the market.

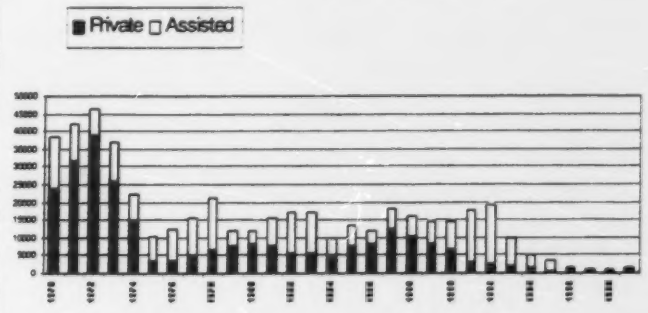
Rental Housing Starts in Ontario

The construction of new rental housing in Ontario has declined from an average of 37,000 (private and government assisted) units annually in the early 1970s to less than 2,000 (private sector constructed) units annually over the past four years.[8] Private rental supply needs to increase dramatically to meet Canada Mortgage and Housing Corporation's estimated requirement for approximately 16,000 new rental units in Ontario, annually, over the next 20 years.

Thus not only is the private sector not producing affordable rental, high end rental is not being produced either. As indicated earlier, this lack of production at the high end has a significant impact on the stock of affordable rental housing as it limits opportunities for higher income tenants to move into new supply, thereby freeing up more affordable units.

Table 4: Government Assisted and Private Rental Starts

Ontario (All Areas Estimate), 1970-1999



source: estimates based on CMHC and MAH data

Most of Ontario's existing rental stock was built by companies building to own and operate their rental property and there are still a number of industry participants who would be interested in both building and owning, should the business

[8] Private sector starts are starts initiated by the private sector for profit and may include starts for which developers have benefited from government loan or grant programs to encourage new private sector initiated supply. Public starts would include public housing starts and non profit and coop starts.

climate improve (many have turned to condo or other development, where there are better returns).

The more typical pattern for rental development today, however, is that of builder/ developers who sell their buildings shortly after construction to institutional investors such as Real Estate Investment Trusts (REIT's) and pension funds. Thus, at present, where there is active rental development, the market tends to be comprised of two sets of players: the builder/developer who builds the building and then sells it shortly thereafter so that their capital can be recovered and used for the next project; and the investor who purchases the building and holds it for the long term as an income investment. While it appears that there is interest in residential rental investment from the second group, there is little interest from the first. This is because the builder/developer requires a higher return on their investment, given the greater risk of building as compared to operating a building. At present, in at least the Province's largest rental markets (Toronto and Ottawa), this higher return is not possible.[9]

Other factors behind the reduction in rental housing production include the imposition of rent controls, which until recently restricted the opportunity for rents to reach free market levels, and the growth of municipal fees and charges as municipalities seek to limit property tax increases at a time when provincial grants have been declining.

Other supply and demand factors have also worked to reduce the role of purpose built rental housing in favour of more attractive substitutes:

- The inequitable property tax treatment of rental housing as compared to ownership housing has encouraged a diversion from rental into condominiums, which are taxed at typically lower ownership housing rates.[10]

- The fact that condominium units can be presold while purpose built rental must be built before it can be rented out has also been a factor favoring condominium construction over purpose built rental. This has consequently aided diversion of high end rental into rented condominiums.

- What would otherwise be demand for high end rental is being channelled into ownership housing, which has become more affordable in today's low interest rate

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[9] A study done for the Ministry by consultants Ernst and Young found that the existing spread between potential returns for builder/developers and investors in both Toronto and Ottawa was not large enough for builder/developers to consider building new average quality rental, even relatively high end rental.

[10] Even before municipalities were statutorily required to tax condominiums at the ownership rate, the excess supply of condominiums in the early 90's encouraged substitution of condominiums for high end rental with abnormally high levels of condominiums rented out. This excess supply has since disappeared and the proportion of rented out condominiums has moderated to about 25%.

environment.

The result is a lack of good quality high end rental and, in larger centres, very low vacancy rates throughout the entire rental market, as opportunities for the filtering down of formerly high end rental to the lower end of the market are limited (See Table 4).

In addition, the existing stock of affordable supply has been subject to pressures for condominium conversion and upgrading to high end rental. Condominium registration allows for more favourable property tax treatment - municipalities must tax condominiums at the ownership housing rather than multi residential tax rate. Upgrading to high end rental, i.e. gentrification of low end stock, provides better investor returns.

Canada-US Comparison

A study done for the Ministry by Ernst and Young examined the impact of taxation, particularly federal taxation, on the construction of multi-residential housing in Ottawa and Toronto, comparing it with that in Boston, Chicago, Dallas and Atlanta.[11] Also examined were differences in several types of returns available to the industry and the identification of key drivers of rental housing production.

It is important to note, with respect to the discussion in this section, that there is no one definitive measure of return when evaluating the desirability of a potential rental investment. Rather, builder/developers and investors use various measures of return, depending on what aspect of a project they wish to focus on.

Sufficient spread between builder/developer and investor returns is a key driver of new rental development. When returns are only sufficient for the long term investor, there is a demand for rental development as an investment - and thus potential buyers for rental projects - but builder/developers will not build as *their* returns are insufficient. Thus the long term investor will only be able to buy existing projects. Returns must be sufficient for both sets of players for new rental development to occur. The measure of return that is used when looking at builder/developer versus long term investor returns is the capitalization rate (cap rate)[12] As can be seen in Table 5 below, the spreads in Toronto and Ottawa are less than those in the U.S. centres - Ottawa's is negative - and considerably below the 2.0-2.5% that the development industry indicates would make building in Ontario viable. (The study indicates that there is significant building in Atlanta and Dallas, which have the highest

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[11] *Comparative Real Estate Finance Analysis*, Ernst & Young study prepared for the Ministry of Municipal Affairs and Housing

[12] **Builders's Cap Rate** (Capitalization Rate) is net operating income (revenues minus expenses before debt payment) as a percentage of purchase price. **Market Cap Rate** is the net operating income available from existing rental projects as a percentage of purchase price i.e. the going return in the market. Cap rates are one of several ways of measuring returns to rental investment. They are a single period rather than multi-year measure because they evaluate the income of an investment over only a portion of its life - in this case a single year. Multi-year measures of return (such as the internal rate of return) are more comprehensive measures of return but not normally used to determine spread.

spreads, although they are both less than 2.0%). It should also be noted that builder/developer returns, as measured by the builder's cap rates in the following table, are 8% higher, on average, in the U.S. cities compared to the Ontario cities.[13]

Table 5
Returns to Builder/Developer

	Toronto	Ottawa	Boston	Chicago	Atlanta	Dallas
Builder's Cap Rate (NOI/Cost)	8.9%	8.3%	9.08%	9.35%	9.06%	9.78%
Market Cap Rate	8.25%	8.5%	8.8%	8.9%	7.6%	8.9%
Spread between Builder's and Market Cap Rate	.65%	-.20%	.28%	.45%	1.46%	.88%

With respect to the long term investor, the study identifies the ability to roll over capital gains tax in the U.S. as significantly affecting the internal rate of return for the long term investor. As can be seen from the table below, the fact that Canadian investors cannot roll over capital gains tax has a significant impact on their internal rate of return.[14] After tax returns, as measured by the internal rate of return, shown in table 6, are at least 25% higher, on average, in the U.S. cities compared to the Canadian cities.[15] (Before tax returns - not in the table - are 14% higher. Even accounting for higher returns before taxes, it is clear that the impact of being able to roll over capital gains is significant.)

In many situations, American investors are able to sell investment real estate (including rental housing) and avoid capital gains taxes. This can be done by buying another property of the same or greater value (so that the payment of capital gains tax is "rolled over" to the next property). This allows investors to actively manage their portfolios, and invest in properties appropriate to their circumstances. The market as a whole benefits as rental investments become more liquid because investors do not delay selling to avoid tax. This

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[13] Calculated as follows from Cap rates in table 5:
(((9.08+9.35+9.06+9.78)/4) -((8.90+8.30)/2)))/8.6 x 100

[14] **Internal Rate of Return (IRR)** is a multi-year and therefore more comprehensive measure of return than cap rates. Unlike cap rates, it can take into account the effect of income taxes on returns. Internal Rate of Return can be defined as the rate of return which equates the discounted value of the cash flow and the after-tax equity residual to the initial equity investment.

[15] Calculated as follows from IRR's in table 6:
(((13.99+13.84+11.56+ 14.63)/4)-((10.12+11.4)/2)))/10.76 x100

has the effect of reducing the required returns going into the investment initially. To the individual investor, the effect of Canadian capital gains treatment is to reduce the expected after-tax returns and decrease liquidity, thereby increasing risk, and increasing the required return on a pre-tax basis.

Table 6
Impact of Rollover Provisions on Internal Rate of Return to Long Term Investor

	Toronto	Ottawa	Boston	Chicago	Atlanta	Dallas
Internal Rate of Return - with no rollovers - as in Canada	**10.12%**	**11.40%**	12.93%	12.54%	10.36%	13.18%
Internal rate of return - with rollovers - as in U.S.	11.76%	13.02%	**13.99%**	**13.84%**	**11.56%**	**14.63%**

The study also shows that the ability to depreciate the building faster in the U.S. than in Canada has a significant impact on the long term investor's average annual return (i.e. after tax cash flows), as shown below in Table 7.[16] Allowable depreciation rates also significantly impact after income tax rates of return. The allowable Canadian rate is 2% in year one, and 4% thereafter, on a declining basis, compared to the U.S. rate of 3.64% a year (straight line, 27.5 years). Over the twenty-year term in this example, the result is that an American investor could depreciate an additional 18% of the capital costs of the building compared to the Canadian investor. The difference is particularly important in the later years of the investment, where the Canadian investor has less and less depreciation available at the very time that the building requires capital infusion. By the end of twenty years, U.S. tax rules result in the asset being 73% depreciated, while in Canada, the asset is only 55% depreciated. Since profit margins are very narrow in the multi-residential investment market, the manner in which the asset is depreciated can have a relatively large impact on after tax returns.

A U.S. style depreciation system would increase after tax (cash flow) returns by 16% compared to Canada's system.[17] Canada used to have much more favourable

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[16] **Average Annual Return** or after tax cash flow, is a simple calculation, and does not take into account all factors. It is the type of measure an investor is interested in, but does not allow for equity build-up or the disposition of the asset at the end of the investment horizon. It simply indicates to the investor that the property will be able to carry itself without additional investment (or perhaps it will need more capital), and gives an indication of the amount of free cash flow that will be available annually. It is one of many measures that an investor may use to assess the desirability of a potential investment.

[17] Calculated as follows from table 7:
((3.24+4.14)/2)-((2.79+3.58)/2)/3.185 x 100

depreciation rules when the majority of rental stock was built but these rules have been tightened over the past 30 years.

Table 7
Impact of Depreciation Provisions on after Average Annual ReturnTax Cash Flows

	Toronto	Ottawa	Boston	Chicago	Atlanta	Dallas
Average Annual Return - Canada	**2.79%**	**3.58%**	n/a	n/a	n/a	n/a
Average Annual Return - U.S.	3.24%	4.14%	**4.30%**	**4.23%**	**2.72%**	**4.71%**

IV Impact of Government Policies on Rental Housing Development

Market Rental Housing

As previously shown, new purpose built rental housing, even at the high end, has not been economic and little has been built since the mid-1970's. A major factor behind the decline in rental housing production was the removal of more favorable federal income tax treatment. Beginning in 1972, a series of reforms to the tax treatment of rental housing was implemented by the federal government in response to concern that the existing system was encouraging speculation.

Tax reform restricted the use of "paper losses" from capital cost allowances (CCA) as tax shelters against income from other sources. As well, tax reform terminated "pooling" which allowed rental owners to avoid recapture of CCA upon disposition of a property if another property was acquired with the proceeds. In subsequent years, further changes included restrictions on the use of soft costs as an upfront deduction for income tax purposes, reductions in the CCA rate, and other measures targeted at restricting the use of syndicated rental tax shelters. (See table 8)

As concluded by the Ernst and Young study described earlier, U.S. income tax treatment is more favourable to rental housing investors (and accordingly private rental production has generally been more than proportionately higher in the U.S. than in Canada since the early 1980's). Capital cost allowance and the treatment of capital gains are the key areas where U.S. tax policy differs from that in Canada. In the U.S., rental investors not in the business of real estate can defer triggering taxation of recaptured depreciation (CCA) and capital gains when a property is sold by purchasing another property of equal or greater value; in Canada, the recaptured depreciation and capital gain are taxed in the year of sale. As well, in the U.S. the taxation of recaptured depreciation is done on the same basis as capital gains taxation, with only a small portion of the gain subject to taxation. The rate of capital cost allowance is also higher in the U.S. (The inability to "roll over" capital gains and the lower rate of CCA in Canada were cited by the Ernst and Young study as key disadvantages faced by Canadian rental developers and investors and significant factors contributing to lower returns in the Canadian Market.)

Table 8: Key Income Tax Rules Affecting Rental Housing

Capital Cost Allowance	Capital Cost Allowance deductions allow the treatment of depreciation on a building as an expense for income tax purposes - and in most cases at a rate in excess of actual depreciation. The CCA claimed on the building is subject to recapture as income when the building is sold, if the sale price exceeds the depreciated value of the building. The use of CCA is attractive in that it can be viewed as an interest free loan until it is recaptured upon the sale of a building. Since 1981, only companies in the business of real estate can deduct CCA losses against other income; CCA losses can not be used by individuals and non real estate companies. Prior to tax reform in 1972, however, all investors in rental housing could deduct CCA from income from other sources. Now individuals investing in rental properties are limited to using CCA to offset income from the property itself - not other sources. Tax reform in 1972 also eliminated the ability to pool rental properties to avoid recapture of CCA at the sale of a building. This applied to both companies in the business of real estate as well as other investors in rental housing. In late 1974, the tax deductibility of CCA on new rental residential buildings from other sources of income was introduced on a temporary basis for individuals and companies not in the business of real estate. This was the Multiple Unit Residential Building (MURB) provision of the Income Tax Act. This resulted in a large number of syndications of new rental projects to investors wishing to take advantage of the MURB tax shelter.
Deductibility of Soft Costs	Soft costs are expenditures incurred by the owner of new rental property which are not related to the actual acquisition of the fixed assets (i.e. land, building and equipment) Allowable soft costs can be deducted from income from the project in calculating tax. At present, the allowable costs for all owners are landscaping, some site investigation costs and financing fees. For companies in the business of real estate, allowable costs also include promotion expenses, legal and accounting fees, mortgage fees, interest fees during construction and property taxes. Generally, other costs are required to be capitalized into the value of the building and depreciated over time. Currently, allowable costs can only be deducted in the period they relate to, not all upfront in the first year. Prior to 1979, soft costs could be deducted upfront in the first year, regardless of the period they related to. In 1981, the types of soft costs allowed were restricted for those not in the business of real estate. Previously, interest and property taxes during construction, architects' fees and building permits were allowed; now these must be capitalized into the value of the building and depreciated over time.

Treatment of Rental Losses	As a general rule, the losses on any rental property can be deducted from income from other sources in order to calculate income for tax purposes. Such losses could result from a situation where rental revenues are insufficient to cover the out-of-pocket expenses associated with the project (that is, the operating costs and mortgage payments) but not depreciation on the building (as discussed above in the CCA section). This has been an on-going disincentive that was put in place to discourage the "flipping" of real estate that occurred in the late 1970's and early 1980's. While the speculative element in the market has disappeared in today's low inflation environment, these provisions remain in place.. In past years, this feature was of particular importance for new rental buildings, which often experienced negative cash flow in the early years of a project.
Treatment of Capital Gains	In calculating income for tax purposes, 50% of any capital gains from the sale of rental properties are included. Prior to tax reform in 1972, capital gains on rental properties were not taxable; following 1972, 50 percent of capital gains were included in income for tax purposes; this was increased to 66.67% in 1988 and to 75 percent in 1990, with last year's federal budget rolling back the percentage to 66.67% and the October 2000 mini budget rolling it back even farther to 50%. In 1985 a lifetime capital gains exemption for individuals was introduced. At the time, the intent was to gradually raise the limits from an initial $20,000 to $500,000 by 1990. The level, however, was capped at $100,000 in 1987 and ultimately removed in 1994. While in effect, this exemption encouraged small investors and increased the supply of non-purpose built rental housing (such as condominium apartments being rented out by their owner).
Designation of Rental Housing as a "Passive" Investment	A longstanding disincentive to investing in rental development is its designation as a "passive" investment in the *Income Tax Act*. While a hotel, motel or farm is considered an "active" small business corporation, rental housing is considered passive, the same as ownership of a stock or bond. As a result, rental properties are ineligible for the tax advantages enjoyed by active small businesses, such as a special low rate of tax provided by way of an annual tax credit, referred to as the small business deduction, generally available on active business income to a maximum of $200,000. Active small business corporations are also eligible for a total lifetime capital gains deduction of $500,000 and can defer payment on a capital gain if they buy another property for the same or similar business.

In addition, the U.S. federal government provides a Low-Income Housing Tax Credit as an incentive for the private sector to produce lower income housing. This is the most significant program available in the U.S. on a national basis.

The low income housing tax credit was enacted by Congress to encourage new construction and rehabilitation of existing rental housing for low-income households and to increase the amount of affordable rental housing for households whose income is at or below specified income levels. In establishing the tax credit incentive, Congress recognized that a private sector developer may not receive enough rental income from a low-income housing project to: 1) cover the costs of developing and operating the project, 2) provide a return to investors sufficient to attract the equity investment needed for development. To spur investment, Congress authorized the states, within specified limits, to allocate tax credits to qualifying housing projects. The credits may be shared among the

owners of a project (equity investors), much as income and losses are shared among business partners for tax purposes. Generally, the investors are recruited by syndicators, and ownership rights are controlled by limited partnership agreements.

The credit offers investors a dollar-for-dollar credit against federal income taxes for investing in low-income housing. Developers raise equity by selling ownership interests in the properties with the purchasers of the equity being eligible for the tax credit. The following table shows how two projects would compare, one using the tax credits and supplying below market rents, and the other being a project with market rents and no tax credits.[18]

Table 9

($000's)

	Project One Using Tax Credits	Project Two* No Tax Credits
Total Project Cost	10,000	10,000
Equity	1,000	5,000
Debt	5,000	5,000
Tax Credits	4,000	0
Rental Income	930	1,250
Operating Costs	400	400
Net Operating Income	530	850
Debt Service	400	400
Cash Flow	130	450
Return on Equity	13%	9%

* Assumes credit replaced with equity

[18] It is assumed that the two projects are physically identical, and that all capital and operating costs are the same. Under the rules of the program, the project with the tax credits would have to supply below market rents for at least 15 years.

Another tax issue is provincial and federal capital tax. In Ontario, capital tax is payable on capital in excess of $2,000,000. Financial institutions, including mortgage lending companies, but not insurance companies, pay capital tax according to the following schedule:

0.6% on taxable capital up to $400,000,000
0.9% on taxable capital over $400,000,00 for deposit taking institutions
0.72% on capital over $400,000,000 for non-deposit taking institutions.

Federal capital tax is calculated as 0.225% on taxable capital over $10,000,000. There is also federal tax on the capital of financial institutions, including life insurance companies.

Capital taxes discriminate heavily against old fashioned capital intensive industries like real estate because of the nature of the asset. In contrast, low capital intensive companies like brokerage firms and high tech software are favoured. Clearly, in the new age economy, capital taxes should be eliminated.

The cost of and access to CMHC mortgage insurance are critical issues for new rental housing production. CMHC is the only source of mortgage insurance for rental housing and thus generally the only way for builders of rental housing to access high ratio mortgages. (In the absence of such insurance, chartered banks are statutorily restricted to lending a maximum of 75% of a project's value.)

Favorable CMHC mortgage insurance terms were a significant factor in promoting rental development in the 1960's and early 70's but terms have become more restrictive over time. Most recently, in 1996, after a number of bad loan losses, CMHC increased the mortgage insurance premiums for rental housing and introduced more restrictive terms.

At present, CMHC charges a 5% fee on an 85% loan for rental housing. This compares to a 2% mortgage insurance fee for homeowners borrowing 85% of the cost of their home. As well, CMHC takes a very conservative approach in determining lending value for a new rental project. Lending value is determined by taking net operating income (rent less expenses and property taxes) and applying a rate of return (capitalization rate) that the lender thinks is appropriate, given their perception of the project's risk, to obtain an estimate of the project's value. The higher the capitalization rate required by a lender, the lower the value of a project, and the smaller the amount of money that will be lent.

In addition to the advantage of being able to obtain a high ratio mortgage, mortgage rates on CMHC insured loans are significantly lower than those on uninsured projects. Thus the accessibility of CMHC mortgage insurance and the stringency of CMHC's evaluation of potential insured projects has a major impact on the economic viability of a proposed project.

Table 9 on the next page shows the impact of CMHC policies on the economics of mortgage financing. The table shows that while mortgage rates and mortgage payments are lower on CMHC insured projects, the amount of equity required is *greater* than under conventional financing except for an 85% mortgage, where it is only slightly less. The equity required for a project is higher than it would be otherwise because CMHC uses a cap rate of 9% in determining the lending value for a new rental project (lending value = NOI/cap rate) as compared to a market cap rate of 8%. (It is important to note that the actual project cost is irrelevant in determining lending value and the amount of equity required for the project will increase significantly, as the required cap rate goes up and resultant lending value decreases and thus the amount of borrowed money available to apply to the project cost.) The impact of mortgage insurance premiums is also evident from the table, increasing total financing (loan amount + mortgage insurance amount), although only in the case of an 85% loan does total financing with mortgage insurance exceed that of conventional financing.

Table 9
Mortgage Financing Options
High-End High Rise Rental Project, Downtown Toronto
($ per unit)

	CMHC Insured			
	85% LTV*	80% LTV	75% LTV	Conventional Financing
Project Cost	161,380	161, 380	161,380	161,380
NOI	12,467	12,467	12,467	12,467
Cap Rate Used to Determine Lending Value	9%	9%	9%	8%
Value for Lending Purposes	138,522	138,522	138,522	155,838
Loan/Value Ratio	85%	80%	75%	75%
Loan Amount	117,744	110,818	103,892	116,879
Equity Required	43,636	50,562	57,488	44,501
Mortgage Insurance				
- **Premium**	5.5%	3.0%	2.5%	0
- **Amount**	6,476	3,325	2,597	0
Total Financing	124,220	114,142	106,489	116,879
Assumed Mortgage Rate	5.75%	5.75%	5.75%	6.5%
Annual Mortgage Payments	8,184	7,520	7,016	8,390

* LTV is loan to value ratio - loan amount as a percentage of value for lending purposes

Source: Adapted from Exhibit 3-9 in *Responding to the Challenge: The Economics of Investment in New Rental Housing in 1999*, prepared for the Ministry by economic consultant Greg Lampert

Impact of Government Supply Programs

With the changes to the tax climate significantly reducing private sector rental construction - the tap was turned off on the production of market rental housing - there were limited opportunities for filtering down. Government supply programs moved in to fill the gap through both subsidies to private developers and non-profit housing.

The result was that rather than supplementing the rental market at the affordable end, government programs were needed to produce virtually all affordable and moderate rental housing. As a result, the cost to governments became unmanageable.

Other types of government tools to support affordability became less effective - in particular shelter subsides. With no new supply, these are less effective and can be prohibitively expensive if universally applicable to all households. However, in an active market, they provide the most flexible and efficient way to address affordability programs i.e. let the customer decide.

Municipal Policies

Municipalities in Ontario have not been involved in the direct provision of housing programs, with some minor exceptions, until recently. Municipalities have traditionally influenced housing stock through municipal by-laws affecting what gets built (land development) and what it looks like (built form). In recent years, some municipalities have started their own supply side programs, adopted social housing policies, and/or created non-profit housing corporations to develop and manage social housing.

In the 1980s and 1990s, the most significant municipal contributions to housing production, other than direct provision of social housing through senior level programs, were policy initiatives and regulatory changes to enable non-profit and co-operative developers to build social housing. For instance, some municipalities passed special parking requirement by-laws for social housing, where residents were shown to own cars less frequently than tenants in other forms of rental. For the most recent municipal efforts to promote the building of affordable rental housing, see Appendix I.

Municipalities have asked the province for authority to provide financial incentives to for profit private sector partners for the development of affordable housing. (At present, municipalities can only provide such incentives to non-profit corporations.) Municipalities would be required to enter into an agreement with the private sector partner to ensure that affordable housing will result in exchange for the financial incentive. This authority would complement the new municipal role of social housing providers, enhancing municipal ability

to respond to local needs for affordable housing.

While municipal policies can have a significant positive impact on rental housing, municipal policy also has the capacity to be a significant negative influence. This is most often seen with respect to property taxes and development charges and other fees.

Although there have been some reforms to the property tax system, multi-residential rental buildings (purpose built rental buildings) still generally pay disproportionately high property taxes compared to ownership housing. With the introduction of the Ontario Fair Assessment System (OFAS), municipalities now have *discretionary* authority to tax multi-residential buildings at the same rate as ownership housing. (This would mean that an ownership building and a multi-residential building with comparable assessment would be taxed at the same rate so that they would pay the same amount of property taxes) This can not be done without significant political cost, however, as equalizing property tax rates between multi-residential and ownership housing would mean that ownership housing would have to assume a greater proportion of the property tax burden. Only in areas with rapid assessment growth is it likely that there will be any voluntary municipal action on reducing the tax rates on multi-residential properties.

This inequity has a profound effect on both the supply and affordability of rental housing:

- Net operating income from rental projects - a key determinant of lenders' willingness to finance new rental projects - is reduced. Thus projects that would be economically viable at lower tax rates are unable to obtain financing and do not proceed;

- There is an incentive to demolish or convert rental buildings into housing forms (such as condominiums) that are subject to a lower tax rate; and

- Rents are higher than they would be otherwise as landlords pass on some or all - depending on the tightness of the market - of the higher taxes to tenants.

While municipalities which do not want to equalize tax rates between ownership and all rental housing have the option of creating a new tax class for new rental housing and taxing it at a lower rate than existing rental, projects can only stay in the new class for eight years. Industry analysts have argued that this favourable tax treatment is not in place long enough to make a significant difference to the economic viability of potential projects. With 25 or 30 year amortization periods, improved revenues in the first eight years are not significant to lenders.

Some examples of the ratio of multi-residential to single family tax rates:

- Hamilton 3.079
- London 2.382

- Ottawa 2.317
- Sudbury 1.957
- Toronto 5.079
- Waterloo 3.229
- Windsor 2.52

In addition to typically applying higher tax rates to multi-residential housing than comparably assessed ownership housing[19], municipal fees and charges can add considerably to development costs. For instance, most of the suburban municipalities in the Greater Toronto Area have substantial development charges. In Mississauga, development charges for apartment units of 750 square feet or more total $11,162 per unit.[20] In addition, the cost structure of such charges often provides a significant disincentive to multi-residential development as compared to the development of single family ownership housing, with charges levied on multi residential proportionately higher than on single family ownership housing.

The City of Toronto is phasing in a development charge on new rental apartment projects which will reach $1,692 and $2,644 per unit for 1-bedroom and 2-bedroom units, respectively, in September of this year. Municipal building permit and development application fees on rental units in Toronto typically add at least another $1,000 and the city's parkland dedication requirement can add a further $1,000 to the per unit cost.[21] The city also makes significant use of section 37 of the *Planning Act*, which provides municipalities with authority to require concessions from developers in exchange for additional height or density. Other charges in the works are the proposed Toronto District Catholic School Board charge of $2000 plus the proposed Greater Toronto Transit charge of over $1,000. These charges are a major "new" threat to affordable housing and will make the current situation even worse.

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[19]Since implementation of the Fair Municipal Finance Act in 1998, municipalities *must* tax condominiums at the ownership housing rate. Thus a building that with condominium registered units typically enjoys significantly lower taxes than a building that is purpose built rental.

[20]As noted by consultant Greg Lampert in *Update on the Economics of Investment in Rental Housing*, prepared for the Rental Housing Supply Alliance, December 1999.

[21] As noted by consultant Greg Lampert in *Update on the Economics of Investment in Rental Housing*, prepared for the Rental Housing Supply Alliance, December 1999.

Recent Provincial Initiatives to Encourage New Rental Supply

Since 1995, the provincial government has undertaken a number of initiatives to encourage private investment in the construction of new rental housing and the maintenance of existing stock. These include:

- The Tenant Protection Act, (1998) which encourages investment in rental housing by allowing landlords to set market rents on vacant units and recover, at a rate of 4% a year, money spent on capital improvements. (Sitting tenants are still protected by rent control, with the maximum allowable annual increase being the annual guideline increase plus the recovery of capital improvement costs, up to 4% a year, if applicable).
- Regulations put in place by the Fair Municipal Finance Act (1998) provide that condominium registered units must be taxed at the same rate as ownership housing, whether they will be used for rental or not; and municipalities were given permissive authority to reduce the tax rate on multi-residential housing (rental apartments) to near or equal to the tax rate on ownership housing - if they choose to do so. Municipalities now also have permissive authority to create a separate property tax class for new rental and tax it alone (rather than all rental) at a more favorable rate for up to eight years.
- The land use approvals process was streamlined to make it faster and easier to get land ready for development.
- The Ontario Building Code was amended (December 1999) to encourage new single room occupancy (SRO) rental units.
- A $2000 grant to offset the impact of the Provincial Sales Tax on affordable rental unit construction was implemented (Fall 1999) (The recent federal budget introduced a similar program for the GST)

Despite these changes, developers are still reluctant to consider even high end projects due to the unfavorable tax regime, competition from ownership housing and the potential for changes to rent controls. While the initiatives listed above have been positive, labour and material costs have risen. Alternative forms of investment (e.g. condominium and commercial development, stocks, etc.) generally have higher returns and/or are seen as less risky. (In particular, the development industry repeatedly mentions that the existing system of rent control is always vulnerable to change - it has changed significantly in the past - so the potential always exits for projected revenues to be significantly less than anticipated.) This induces investors (and those who provide financing) to see rental projects as riskier than they would otherwise and to compensate for this risk by seeking a higher return on rental investments.

V Recommendations

Two key conclusions emerge from the discussion in this interim paper[22]:

- The high end of the market is a critical component in developing an effective long-term strategy to promote affordable housing. The market as a whole has to be working before governments develop strategies to specifically promote development of affordable housing. Otherwise the cost burden on government is too high.

- There is a role for government in addressing affordability in addition to addressing the economics of purpose-built rental. The effect of a government incentive or subsidy is to reduce the rent for the individual who is renting the unit - this can be done through subsidy to the developer to offer reduced rent, or through a subsidy to the individual. Subsidy programs can also "skew" developers' choices somewhat so that more modest accommodation is built.

In this section of the report, a number of recommendations are put forth. It should be noted, however, that they are, in fact, interim recommendations only. They will be developed further, and refined as necessary, in the Housing Supply Working Group's final report.

Purpose built, high end rental development is a critical component of any affordable rental supply strategy and steps need to be taken to build a viable rental development market. The Housing Supply Working Group believes that a sustained improvement in the investment environment is the best way to encourage a return to a viable rental development market. There is a need to focus on the economics of rental supply in a fundamental way which deals with the disincentives in the tax system. The Working Group agrees that key tax climate changes should be considered.

Recommendation 1 **It is recommended that the Province and industry work with the federal government to identify key changes to the tax system which would stimulate rental supply. This should include consideration of**

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[22] It should be noted that the City of Toronto has come to similar conclusions in its draft report, *Towards an Action Plan to "Make Rental Housing Happen"*. This report notes that a consensus is emerging with respect to two issues:

> "on the need to re-establish a rental industry in Canada that will build and manage new conventional rental accommodation over the longer term; and
>
> the fact that, in order to re-establish a rental industry, a level playing field has to be created for rental housing."

Towards an Action Plan to "Make Rental Housing Happen" was developed with representatives from the building and development industry, many of whom are also part of the Housing Supply Working Group. *"Towards an Action Plan to "Make Rental Housing Happen"* contains a number of recommendations that are similar to the ones developed by the Housing Supply Working Group.

rollover provisions; pooling; passive vs active designation; GST, and Capital Tax. In particular, given the conclusions of the Ernst and Young study comparing rental economics in the U.S. with those in Ontario, it is recommended that particular attention be paid to the ability to rollover capital gains tax and the amount of allowable annual CCA deduction.

The Housing Supply Working Group notes that, even with improvements in the economics of rental housing development, access to financing remains a critical factor.

Recommendation 2a — **It is recommended that the Province and industry work with the federal government to identify changes to CMHC lending practices which would encourage rental development. This would include reviewing insurance fees for high ratio loans for rental housing and the determination of lending value for rental housing.**

Recommendation 2b — **It is further recommended that, in the absence of federal government action to address the current disincentives with respect to CMHC mortgage insurance, that research be undertaken to determine the feasibility of the Province providing mortgage insurance for rental housing construction, directly or underwriting CMHC mortgage insurance.**

Strategies to directly address affordability should complement the approach taken in dealing with the broader rental market (affordable and higher end rental) and therefore focus on the role of the private sector.

Recommendation 3 — **It is recommended that the federal and provincial governments consider U.S. type tax incentive systems such as the Low Income Housing Tax Credit as well as shelter subsidy programs to promote affordability in a private market.**

As well, it should be noted that while much of the discussion in this paper has focussed on the federal tax environment, there is a role for all levels of government in promoting a healthy rental investment environment and developing initiatives to address affordability more directly. In particular, municipalities, who now have responsibility for social housing in Ontario, need to have broader legislative authority to deal with housing issues. Further

analysis and research will be undertaken by the Housing Supply Working Group to develop and refine additional recommendations within the municipal jurisdiction for the Working Group's subsequent report.

A key issue within the municipal jurisdiction is the proportionately heavier property taxes borne by apartment buildings as compared to ownership housing. Any reduction in property taxes on new rental housing improves the economics of rental housing investment. As such, the Housing Supply Working Group is proposing the following:

Recommendation 4 — **It is recommended that the Province provide municipalities with authority to provide favourable property tax treatment (same as ownership housing) indefinitely. This would replace the current authority which provides for favourable property tax treatment for a maximum of eight years.**

Municipalities have expressed a need to enter into agreements with private sector developers for the development of local affordable housing. This would involve providing a private sector development with some direct or indirect financial benefit in return for the development of affordable housing. As such, the Housing Supply Working Group is proposing the following:

Recommendation 5 — **The province should allow municipalities to enter into agreements with the private sector for the creation of affordable housing under section 210.1 of the *Municipal Act*, which would enable municipalities to provide a financial incentive to a private sector corporation for the development of affordable housing.**

As discussed throughout the report, development charges and planning fees can have a significant negative impact on the economics of new rental development. As such, the Housing Supply Working Group is proposing the following:

Recommendation 6 — **It is recommended that the *Development Charges Act, Education Act* and the *Planning* Act be reviewed by the Province to ensure that development charges, planning fees and municipal approvals processes do not discourage the development of affordable housing. As well, the impact of other municipal impediments to**

affordability such as Section 37 charges on rental should be looked at as well as measures to encourage zoning and approval of rental housing.

Recommendation 7

The Housing Supply Working Group also believes that further consideration should be given to the following issues, with recommendations developed at a later date, as appropriate: encouraging municipalities to adopt zoning that allows for accessory apartments; and encouraging municipalities to equalize tax rates between ownership and rental housing.

The Provincial Sales Tax can have a significant impact on the economics of rental development. While the Province does provide a $2000 grant to offset the impact of the PST on the construction of purpose built rental units, most development that is occurring is condominium registered. As such, the Housing Supply Working Group recommends the following:

Recommendation 8

It is recommended that the current PST offset grant of $2000 per affordable rental unit constructed be extended to include condominium registered rental units as well as purpose built rental.

There are presently more applications under the PST Grant Program than can be accommodated under the present program allocation.

Recommendation 9

It is recommended that the program funding be increased so as to be available for all eligible applicants and that the program be extended beyond 2002.

The more affordable home ownership is, the more likely it is that tenants will be able to purchase a home and leave the rental market, thereby reducing demand for rental housing. As such, the Housing Supply Working Group recommends the following:

Recommendation 10

It is recommended that consideration be given to eliminating the PST on mortgage insurance for home owners

Recommendation 11

It is recommended that consideration be given to extending the current PST offset grant to building

materials used in the construction of affordable ownership homes.

The industry is concerned about potential changes to rental legislation in the future which would restrict investment in new rental housing. It is therefore recommended that:

Recommendation 12

Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures. Such binding assurances would improve access to capital and encourage long-term financial commitments.

Summary of Recommendations

Federal	Province and industry to work with the federal government to identify key changes to the tax system which would stimulate rental supply, including rollover provisions; pooling; passive vs active; GST; and Capital Tax. It is recommended that particular attention be given to the ability to rollover capital gains tax and the amount of allowable annual CCA deduction. Province and industry to work with the federal government to identify changes to CMHC lending practices which would encourage rental development, including insurance fees for high ratio loans for rental and the determination of lending value for rental. Federal government asked to investigate U.S. type tax incentive systems such as the Low Income Housing Tax Credit
Provincial	In the absence of federal government action to address the disincentives with respect to CMHC mortgage insurance, research be undertaken to determine the feasibility of the Province providing mortgage insurance for rental housing construction, as an alternative to CMHC. Province to investigate U.S. type tax incentive systems such as the Low Income Housing Tax Credit Province to investigate shelter subsidy programs to promote affordability in a private market. Current PST offset grant be extended to include condominium registered rental units. Program funding for PST Grant be increased so as to be available for all eligible applicants and program be extended beyond 2002 Consider eliminating PST on mortgage insurance for home owners Consider extending PST offset grant to building materials used in construction of affordable homes. Possible mechanisms be explored which would enhance stability for investors in the future through contracts, performance bonds or other measures.
Municipal	The Province to provide municipalities with authority to provide favourable property tax treatment (same as ownership housing) to new rental indefinitely. Province to allow municipalities to enter into agreements with the private sector for the creation of affordable housing, which would enable municipalities to provide a financial incentive to a private sector corporation for the development of affordable housing. Province to review Development Charges Act, Education Act and the Planning Act to ensure that development charges, planning fees and municipal approvals do not discourage affordable housing. Further consideration to be given to the following issues at a later date: encouraging municipalities to adopt zoning that allows for accessory apartments; and encouraging municipalities to equalize tax rates between ownership and rental housing.

APPENDIX

SURVEY OF SELECTED MUNICIPALITIES ON EFFORTS TO PROMOTE THE BUILDING OF AFFORDABLE RENTAL HOUSING UNITS

TORONTO

- The City of Toronto has approved a $10.9 million Capital Revolving Fund to help develop affordable housing. This has levered the approval of 384 housing units and Single Room Occupancy (SRO) units. A second tranche is pending approvals and will in conjunction with the first lever some 800 housing units and SRO units in total. Toronto is expending some $30,000 per unit in cash, land and forgone fees to create each SRO unit.
- Established a special property tax class for new multi-residential rental housing to give it parity with condominiums for a period of eight years.
- Rebated development charges for new rental housing units.
- Approved secondary/accessory units as of right in all single and semi-attached houses in the City.
- Granted building density bonuses to builders constructing affordable housing.
- The current vacancy rate in Toronto is 0.6%.

OTTAWA

- The city has waived all development charges, building permit fees and the parkland dedication for those building affordable rental units. About $500,000 in fees were waived for the year 1999.
- Property taxes on rental units have be equalized with condominiums for an eight year period.
- Used federal Residential Rehabilitation Assistance Program (RRAP) money and local incentives (see above) to build out two floors in the Union Mission and create 60 units in an existing office building. The Sterling Hotel yielded 10 units and a former storage facility was converted to 7 units. In total some $3.5 million of RRAP money has been allocated and spent in Ottawa.
- The Regional Municipality has taken the $1,000,000 surplus in the social housing budget and has created a $20,000 per unit grant for rental construction and conversion. The rent supplement money from the federal devolution was also pressed into service. Seven regional properties have been offered for a dollar each to builders of rental units. To date 150 units have been approved 75 of which are through the Nepean Housing Corporation. All units are under the rubric of non-profit organizations.
- The current vacancy rate in Ottawa is 0.2%.

WATERLOO

- Waterloo Region has set up a Social Housing Reserve Fund (SHRF) utilizing $4,000,000 in surplus funds. There has been issued a $600,000 RFP to non-profits and co-operatives out of the SHRF to solicit proposals to build or convert buildings to affordable rental units. The region intends to grant about $10,000 to $20,000 per unit.

- The Region wishes to co-ordinate RRAP monies and federal homelessness programs which are currently administered by several area municipalities in a patchwork manner.

- Kitchener has waived development fees, building permit fees, parking requirements and park land dedication requirements for those building rental units in the downtown core. Furthermore, the City has given a property tax holiday of three years amounting to the difference between the undeveloped and developed rate.

- The City of Waterloo has waived development charges on rental buildings in the core. Cambridge has done the same but has also waived building permit fees.

- The Kiwanis have proposed a twenty unit SRO under the SHRF.

- An inventory of municipally owned land being created.

- The finance department is looking at a proposal to lessen property tax rates on multi-residential rental buildings.

- The current vacancy rate in Waterloo Region is 0.7%.

PEEL

- Peel Region wishes the private sector to own and operate affordable rental housing in Peel. Peel has no housing policy as yet other than to run some ownership demonstration projects to show the way. Pilots and demonstrations, it is reasoned, will ultimately help inform the policy direction and bolster private resolve to get involved.

- There is no general waiving of development charges, building permit fees or property tax relief.

- There are two pilots in the works. The Region is going to develop 130 seniors' units on Peel Living land. The region will retain a builder, provide the interim financing and probably the capital financing. Development charges are to be waived in this case.

- The Region will also develop 54 SRO units on Regional land. They will be 250 square feet per unit and be constructed as stick built walk ups. The units will rent for $450 to $500 per month with some units less if the rent supplement money is allocated here. Development charges do not apply on Regional lands. Here again Peel will finance with its own money or borrow with its AAA rate.

- The RAAP is not mature in Peel and will be used to build shelters and renovate rooming houses.

- **The current vacancy rate in Peel Region is in the 0.6% to 0.7% range.**

HAMILTON

- **Hamilton's housing efforts are confined to the downtown core. The City has created a Convert/Renovate to Residential Loan Program which allocates some $10,000,000 in loans to downtown buildings for non-residential conversions to residential or for renovation of existing units in poor shape. The loans are interest free for ten years.**

- **In addition some $1.7 million in RRAP funds are administered by the City.**

- **The Hamilton Housing Company has made a capital grant of $1.5 million for the demolishing and re-build of the corner of King and Walnut which will yield new commercial and eight housing units.**

- **Council is currently looking at the creation of an Affordable Housing Fund, which would be a revolving fund of $800,000.**

- **The current vacancy rate in Hamilton is 1.7%.**

WINDSOR

- **Windsor has no current initiatives to build or encourage rental construction.**

- **The current vacancy rate in Windsor is 1.9%**

THUNDER BAY

- **The City has no specific initiatives to encourage rental construction. However as an attempt to improve development in the downtown core they have brought in four programs under the Commercial Improvement Programs for the Core Area in 1998. These programs include rebates of building permit and development fees, facade improvement loans, adaptive re-use study grants of up to $15,000, and property tax rebate grants to owners on the net margin of property tax increase caused by re-assessment on core buildings till the year 2008.**

- **Parking and yard requirements in the core have been softened.**

- **As part of the Official Plans process Thunder Bay is seeking to encourage greater multi-family development in the core and on brownfields.**

- **The current vacancy rate in Thunder Bay is 5.8%.**

NIAGARA

- **Niagara has no initiatives at the current time for the provision or encouragement of new rental units.**

- **The vacancy rate in Niagara is 2.6%.**

LONDON

- **London has no initiatives at the current time for the provision or encouragement of new rental units.**
- **The vacancy rate in London is 2.2%.**
- **The building reserve fund is currently sitting at $1.5 million but it is underfunded by $3 million just as a capital replacement reserve fund. The fund was created as interest rates dropped and it was hoped that new units could be built from the fund. Repair and maintenance of existing units, in more than 50 projects, will preclude the expenditure of money for new units until at least 2002 or 2003.**

OSHAWA

- **There is a downtown intensification study being done at the present time which is looking at the lessening of development charges in downtown Oshawa to encourage residential development in the core.**
- **Oshawa has a 1.7% vacancy rate.**
- **The predominant building form in Oshawa is freehold row housing. This is an ownership model which delivers intrinsically affordable housing to large numbers of families.**
- **There are no programs or lessening of fees to encourage the building of social or affordable housing by non-profits or co-operatives or the private sector at the present time.**

SUDBURY

- **Sudbury has a 7.7% vacancy rate.**
- **Sudbury has no development charges for housing built in the downtown core. Beyond that Sudbury has no active programs to encourage the building of affordable rental housing.**

CONCLUSION

- **There is a wide diversity of housing markets and problems at the municipal level. We can observe very different local municipal responses to these diverse housing situations. For example, municipalities with low vacancies tend to put more effort and cash into the building and encouraging of new rental affordable housing than those municipalities which have higher vacancy rates.**